

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of)

Implementation of Sections of)
the Cable Television Consumer)
Protection and Competition Act)
of 1992)

Rate Regulation)

MM Docket 93-215

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

To: The Commission

**COMMENTS OF PRIME CABLE, HARRON COMMUNICATIONS
CORP., GEORGIA CABLE PARTNERS, ATLANTA CABLE
PARTNERS, L.P., WOMETCO CABLE CORP, AND
THE COALITION OF SMALL SYSTEM OPERATORS**

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SUMMARY

These Comments, submitted on behalf of small and medium-sized MSOs, respond to the Commission's Cost-Of-Service NPRM. The focus of the Comments is on the rate base, urging the FCC to permit cable operators to recover in their rates the investment cable operators reasonably have made prior to rate regulation in order to provide cable television services to their subscribers.

When a person plans to construct a cable system, he must raise enough money to (1) pay for construction, (2) cover predictable deficits during the start-up phase, and (3) cover the interest necessary to carry this entire amount over that period. These amounts must all be included in the rate base and depreciated (or amortized) over the useful life (or investment cycle) of the assets. Because no depreciation or amortization can be recovered until operating cash flow is positive, these expenses must also be deferred until that time. The rate base, on which the Commission is required to permit the cable operator an opportunity to earn a return, must include all these components.

The right of rate regulated entities to be given an opportunity to actually recover their depreciation, start-up costs, and interest during a period of operating deficits is grounded in precedents developed at the FCC and other regulatory commissions, and affirmed in long lines of judicial decisions. Although cable systems are different from traditional public utilities in that cable systems do not offer an "essential" service, and they typically take longer to build up a customer base and achieve positive net income, their right to recover and earn a return on the investment necessary to deliver service is no different.

Where a system has been acquired after construction, the cable operator cannot fairly be limited to the original operator's rate base. For

acquisitions made in an unregulated environment in an arm's length transaction, the Commission may not exclude a portion of the purchase price from the rate base. At least as a transitional matter, the Commission must permit existing rates to be justified by including all acquisition costs in the rate base. Recent decisions by the Commission dealing with the acquisition of other unregulated companies by regulated carriers have established this same principle.

For all purposes, including future justification of rate increases, the Commission must, at the very least, allow cable operators to include in their rate bases that portion of their acquisition costs represented by the reproduction cost of the systems acquired (depreciated) as well as the predictable start-up deficits (and interest) requirements necessary to bring the system to profitability. In determining a minimum value of the acquired system, the Commission should look to what investment the purchaser would have to make to reproduce the system (recognizing its age) and cover the start-up deficiencies the system would incur until the system reached economic viability. This amount (including the interest necessary to carry the investment until principal can begin to be repaid) equals the system's reproduction cost (depreciated), its predicted deferred (unrecovered) start-up costs, and an interest component. The rate base, as depreciated and amortized from the date of acquisition, may contain no less. In addition, where the acquisition can be shown to have created operating efficiencies, the rate base should be further adjusted.

Tony Kern, Senior Manager of Arthur Andersen's Telecommunications practice, has analyzed the operations of more than 6,000 cable television systems in a cable television consulting practice spanning more than a decade. He has used his experience and extensive database to produce cost-of-service models that incorporate these traditional regulatory principles. These models allow cable operators either to rely on the "original cost" of their systems as constructed and

their actual deferred start-up costs, or to rely on industry average determinations of reproduction and deferred costs (based on the system's particular characteristics). The models, along with Mr. Kern's supporting declaration, are attached as Exhibits to these Comments.

Finally, the Comments note that the Commission is obligated under the 1992 Cable Act to simplify rate regulation for cable systems with less than 1,000 subscribers. The administrative burden on small systems from regulation and the higher-than-average costs per subscriber incurred by small systems are not materially affected by whether the system is owned by an unaffiliated operator or a MSO. The Comments request the Commission to permit small systems to rely on a simplified "net-income" approach to rate regulation. Where a more complete cost-of-service analysis is required, we propose a model that reduces the information required from the operator. In all cases, we request the Commission to permit small systems to use their consolidated accounting systems in place on April 1, 1993.

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On behalf of Prime Cable ("Prime Cable"), Harron Communications Corp. ("Harron"), Georgia Cable Partners ("Georgia Cable"), Atlanta Cable Partners, L.P. ("Atlanta Cable"), Wometco Cable Corp. ("Wometco"), 1 and the Coalition of Small System Operators (the "Coalition"), 2/ we submit the following

1/ Prime Cable, Harron, Georgia Cable, Atlanta Cable, and Wometco are all cable television multiple system operators (MSOs) of moderate size which, through their various corporations, partnerships, and affiliated entities, own and operate numerous cable systems in various states. Prime Cable owns and operates nine cable systems in six different states serving over 500,000 subscribers, Harron owns and operates approximately 200 cable systems in seven different states serving in excess of 225,000. Georgia Cable, Atlanta Cable, and Wometco are related entities which collectively own and operate cable systems serving in excess of 400,000 subscribers. These Comments are based on their perspective as large cable operators serving multiple franchise jurisdiction cable systems.

2/ The Coalition of Small System Operators consists of: ACI Management, Inc.; Balkin Cable; Buford Television, Inc.; Classic Cable; Community Communications Co.; Douglas Communications Corp. II; Fanch Communications, Inc.; Frederick Cablevision, Inc.; Galaxy Cablevision; Harmon Communications Corp.; Horizon

Comments to the Federal Communications Commission's Notice of Proposed Rulemaking, FCC 93-353 (released July 16, 1993) ("NPRM"), in the above-captioned proceeding. These Comments do not address each of the issues raised in the NPRM but, rather, focus upon the underlying framework of the cost-of-service standards. Specifically, these Comments urge the FCC to adopt cost-of-service standards that will permit cable operators ultimately to recover the investment they reasonably and prudently made prior to rate regulation in order to provide cable television services to their subscribers.

The main issue to be addressed in connection with the cost-of-service standards involves what costs properly are included in cable operators' rate bases. Traditional cost-of-service analysis allows regulated entities to recover reasonable operating expenses, 3/ depreciation, taxes, 4/ and a reasonable return as a

Cablevision, Inc.; Leonard Communications, Inc.; MidAmerican Cable Systems, Limited Partnership; Mid-American Cable Television Association; Midcontinent Media, Inc.; Mission Cable Company, L.P.; MW1 Cablesystems, Inc.; National Cable Television Cooperative, Inc.; Phoenix Cable, Inc.; Rigel Communications, Inc.; Schurz Communications, Inc.; Star Cable Associates; Triax Communications Co.; USA Cablesystems, Inc.; and Vantage Cable Associates. Coalition members own and operate approximately 2,784 headends (representing more than a quarter of the headends in the country), serving approximately 1,297,856 subscribers. Coalition member Mid-American is an association of cable operators serving 1,458,644 subscribers in 1,479 communities located in Kansas, Missouri, Nebraska and Oklahoma. The members of Mid-America have 918 systems with less than 1,000 subscribers. The National Cable Television Cooperative is a purchasing cooperative which represents 360 small and mid-size independent cable companies. These companies together serve more than 2.8 million subscribers in over 2,300 communities nationwide. The Coalition participated in the rate regulation rulemaking by filing comments (dated January 27, 1993) and reply comments (dated February 11, 1993) and a Petition for Reconsideration (dated June 21, 1993). The Coalition has the special perspective of small system cable operators. See Section V. supra.

3/ We do not address in detail in these Comments the FCC's proposal in its NPRM regarding cable operators' recovery of certain annual expenses. NPRM at ¶¶ 23 - 30. However, in brief we think, and the accompanying model contemplates, that cable operators should be entitled to recover in their rates all of their operating

percentage of the rate base. However, what comprises the rate base for cable systems is a complicated matter because cable systems' rates typically have been unregulated in the past, cable systems often have been bought and sold (sometimes several times) since construction, and the substantial investment necessary to construct (or acquire) a cable system typically is recovered only over a lengthy period of time. 5/

expenses including, but not limited to, plant specific costs (e.g., maintenance), plant non-specific costs (e.g., programming expenses, power, engineering and testing), customer operations (e.g., marketing, billing and collection), and corporate operations (e.g., legal, planning, accounting and finance). We also think, though the accompanying model currently does not contemplate, that cable operators should be entitled to include programming expenses in their rate bases and that cable operators should be entitled to a profit on such programming expenses for the development of cost-based rates as suggested. NPRM at ¶ 24, n.24.

Although we do not oppose the principle of excluding certain expenses, such as lobbying expenses, from the pool of expenses that may be recovered, we believe that these expenses are generally small and that most cable operators do not keep these expenses separately on their books. In our view, whatever precision in regulation could be gained from excluding certain minor expenses such as these would be lost in the administrative nightmare that would be caused. Accordingly, we oppose such refinements in the cost-of-service regarding both large and small systems.

4/ We also do not address in detail in these Comments the FCC's proposal in its NPRM regarding cable operators' recovery of certain taxes. NPRM ¶ at 30. However, we do want to express our disagreement with the FCC's suggestion that while cable operators may include in their ratebase those taxes payable by the business entity, they may not include income taxes payable on income from cable operations by individual owners, partners or Subchapter S Corporation owners. NPRM at ¶ 30, n.32. The FCC's proposal would unfairly penalize cable systems, which have structures other than pure corporate relationships, especially those cable systems, which are owned by a few investors who, for tax purposes, may have formed a Subchapter S Corporation or sole proprietorship to conduct the affairs of the system. Taxes should be recovered by the cable system under the corporate tax rate, even when the actual tax obligation is passed through directly to the system's owners.

5/ Because neither the FCC nor the courts have often had occasion to address what components should comprise the rate base of telecommunications entities

Cable operators acquire their systems in one of two ways. Either they construct the system, or they purchase the system from another entity following construction. Any person who contemplates constructing a cable television system necessarily must raise enough up-front investment to cover not only construction of the cable system's plant and facilities, but also extensive expenses incurred in the start-up phase that generally cannot be recovered for a lengthy period. In addition, that person must raise sufficient capital to cover interest payments on borrowed funds during this initial operating period. And the cable operator must anticipate that during its early years of operation, the system's revenues will not be sufficient to cover the system's depreciation. Of course, all of this initial investment must ultimately be recovered, along with a sufficient return on that investment to justify making the investment in the first place. Accordingly, in those instances where cable operators have constructed or rebuilt their systems, the cost-of-service standards must provide for sufficient revenues over the life of the investment to allow cable operators ultimately to fully recover all of their reasonable investment, including the early-year deferred start-up expenses and interest payments, as well as depreciation and a reasonable return on their investment.

Many cable operators have acquired their systems from other entities following construction. The prices for which cable systems historically have been sold often have been considerably higher than the depreciated cost of their facilities alone. However, the FCC should not assume that the prices for these systems were

entering the realm of rate regulation, as invited by the FCC in its NPRM at ¶ 15, we explore what other federal and state regulatory bodies have done in situations similar to this. While we rely on decisions and/or rulings of these other regulatory bodies, we also, of course, reference relevant FCC decisions or rulemakings where applicable.

unreasonably high. 6/ Sale prices of cable systems often have reflected the economic reality that the sellers typically have had to recover their deferred costs as well as their deferred profits at the time of sale. Indeed, in many cases, the only way that cable operators have been able to make any return on their investment has been to sell their systems.

In its NPRM, the FCC has proposed cost-of-service standards governing cable operators' showings to justify rates above levels permitted under the benchmarks and price caps. In our view, in order to ensure that cable operators fully recover their investments in their systems, the FCC must allow cable operators to include in their rate base the following components:

- Cable operators who built or rebuilt their systems should be permitted to include in their rate base (1) the depreciated original cost of the system, (2) all deferred (unrecovered) start-up and early operating expenses, (3) all deferred (unrecovered) interest payments made to borrow funds during the start-up phase, (4) all deferred (unrecovered) depreciation, and (5) all budgeted capital expenditures for the ensuing twelve months after the cost-of-service analysis is prepared.

6/ In its NPRM, the FCC states that its proposed cost-of-service standards "would be based on the presumption that most operators have set rates in an unregulated environment at a level to be fully compensated." NPRM at ¶ 18. We strongly disagree. First, rates often have been set at levels calculated to grow subscribership to break-even levels. As noted above, cable systems uniformly have lengthy periods of losses. Moreover, since the April 5, 1993 rate freeze, cable operators have been prevented from raising their rates to meet ever increasing costs. In many cases, this has resulted in a rise in cable systems' net losses forcing the delay of important capital improvement projects. Even if cable operators set their rates prior to April 5, 1993, at realistic levels to maintain their subscriber base, their inability to increase rates since that date has denied them the reasonable compensation they are due.

- As a transition measure, cable operators that bought their systems after construction, but prior to regulation, should be permitted to include in their rate base the full acquisition cost of their cable systems, depreciated and amortized to the present date, at least to justify existing rates.
- To justify either current rates or rate increases, cable operators should be permitted to include in their rate base, at a minimum, (1) that portion of the acquisition cost that represents the full (reproduction) cost of building the cable system at the time of acquisition (less depreciation reflecting the system's age), plus (2) all of the deferred expenses the cable operator would incur in the start-up phase of operating such a system (amortized and depreciated to the present). In addition, cable operators should be permitted to include in their rate base a sufficient portion of any acquisition premium to produce revenues that reflect any cost savings to subscribers that resulted from the acquisition.

In order to facilitate cost-of-service showings, and consistent with the FCC's proposal that any cost-of-service showings be presented on FCC prescribed forms, Tony Kern, Senior Manager of Arthur Andersen & Co., has developed cost-of-service models. See Kern Declaration attached hereto as Exhibit 1. ^{7/} These models, one of which has been developed for large cable systems (Exhibit 2), and the other for small cable systems (Exhibit 3), not only will reduce administrative

^{7/} We agree with the FCC that any cost-of-service showings be presented on an FCC prescribed form. NPRM at ¶ 19. The models developed by Mr. Kern for both large and small systems would permit regulatory authorities to evaluate cable operators' showings for both the basic tier and cable programming service tiers. A full discussion of these models, including their components and assumptions, is contained in Section VI. supra.

burdens by providing a uniform presentation of cost-based rates for cable service, but also will enable cable operators and local franchise authorities to determine with relative ease whether a cable operator can justify its rates under a cost-of-service showing.

I. Cable Operators Are Entitled To Recover Fully Their Reasonable And Prudent Investments, As Well As A Reasonable Return.

The guiding principle in determining what to include in a regulated entity's rate base is that the entity must be given an opportunity to recover its reasonable and prudent investment in facilities "used and useful" in the provision of regulated service, and to earn a reasonable return on that investment. ^{8/} The precise investments included in the rate base may vary from one industry to another. Indeed, the FCC has recognized that its rate regulations must be "tailored to the cable industry." NPRM at ¶ 15, n.16. ^{9/} But the essence of the rate base

^{8/} See, e.g., Missouri ex rel. Southwestern Bell Tel. Co. v. Public Serv. Comm., 262 U.S. 276, 287 (1923) ("[t]here must be a fair return upon the reasonable value of the [utility's] property at the time it is being used for the public"); Public Service Co. v. FERC, 653 F.2d 681, 683 (D.C. Cir. 1981) ("a regulated utility is allowed to recover from ratepayers all expenses incurred plus a reasonable return on capital invested in the enterprise"); Tennessee Gas Pipeline v. FERC, 606 F.2d 1094, 1109 (D.C. Cir. 1979), cert. denied, 445 U.S. 920 (1980) ("an item may be included in a rate base only when it is 'used and useful' in providing service").

^{9/} Since any cost-of-service standards must be tailored to the cable industry, the FCC should, and must, avoid turning cable cost-of-service analysis into the enormously complex regulation traditionally applied to common carriers. In its Report on the 1992 Cable Act, the House Committee on Energy and Commerce stated that it was "not the Committee's intention to replicate Title II regulation [and that] the FCC should create a formula that is simple to implement, administer, and enforce, and should avoid creating a cable equivalent of a common carrier 'cost allocation manual.'" H.R. Rep. No. 102-628, 102d Cong., 2d Sess., at 83 (1992). Moreover, Congress did "not intend for the [FCC] to create a 'rate of return' comparable to that permitted for telephone common carriers." Id. The FCC recognized Congress' intention when it noted that its "cost-of-service requirement for cable rates will not replicate Title II regulation." NPRM at ¶ 15, n.16. Not only

concept is that the amount of investment that must be raised by a prudent owner in order to provide an adequate utility service must be recoverable. Accordingly, the owner must be entitled by the system of rate regulation to earn a return sufficient on that investment to meet his investors' reasonable "investment-backed expectations" and to permit the owner future access to the capital markets. See, e.g., Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 603 (1944). The system of regulation need not guarantee the owner a reasonable return, but it must permit it.

In this case, Congress has clearly indicated its concurrence with these historic principles and has noted that rate regulation, among other things, should consider the "capital and operating costs of the cable system," Section 623(c)(2)(E), and a reasonable profit, Section 623(b)(2)(C)(vii). ^{10/} In its NPRM, the FCC has recognized that its regulations governing cost-of-service must "permit the recovery of costs for providing cable service" and "not preclude operators facing unusual operating costs [from] recover[ing] such costs in rates for cable service." NPRM at ¶ 12. ^{11/} The FCC also has recognized that its cost-of-service standards "should not

has Congress made its views known, but the FCC must keep in mind that cable operators operate systems that are usually many times smaller than the operations of regulated common carriers. Overly detailed and complex regulation would cause an administrative nightmare for subscribers, cable operators, and regulatory authorities alike.

^{10/} The Conference Committee of the House and Senate, recognizing that cable operators are entitled to a return on their investment, agreed without any argument that Section 623(b)(2)(C)(vii) should permit cable operators to "a reasonable profit . . ." H.R. Rep. No. 102-862, 102d Cong., 2d Sess., at 63 (1992).

^{11/} While we agree that the FCC's "regulatory framework for cost-based rates should be guided by the goal of producing rates that approximate competitive rate levels, i.e., rates that approach the operators' costs," NPRM at ¶ 10, it is vital that any cost-of-service standards recognize that some cable operators' rates may be relatively higher than the "competitive" level because individual operators may face higher costs in providing cable television services to their subscribers. For this

thwart operators' ability to respond to competitive forces by means of facility and service improvements" and must permit cable operators to continue to expand their telecommunications infrastructure. NPRM at ¶ 9.

By not permitting cable companies to recover their entire reasonable investments, including their deferred start-up costs, the FCC would be interfering impermissibly with the cable companies' ability to attract the necessary capital in the financial markets. The FCC also would deprive cable operators of their property and interfere impermissibly with their investment-backed expectations. Any cost-of-service standards must be consistent with Congress' mandate that cable operators not be compelled to provide cable service at rates that prevent them from fully recovering their investment related to the provision of cable television service. Report and Order at ¶ 262; NPRM at ¶ 12.

II. Cable Operators Are Entitled To Include In Their Rate Base The Original Cost of Their Cable Systems, Plus Their Other Unrecovered Costs.

A. Original Cost Methodology Is Appropriate, Provided Operators Are Permitted To Recover All Otherwise Unrecovered Costs.

The FCC has proposed that the rate base for cable cost-of-service regulation include the cable operator's "original cost" of facilities, NPRM at ¶ 35, and we do not disagree. ^{12/} The FCC historically has relied on original cost, United

reason, any cost-of-service standards must be sensitive to the fact that all cable operators do not compete in the same marketplace or face the same conditions and, accordingly, the amount that each cable operator may need to include in its rate base to compete will vary depending upon the market conditions each cable operator faces. Moreover, the FCC may not properly gauge the level of "competitive" rates simply by looking at a database heavy with systems that have competed for only a short time and have not reached a competitive equilibrium, and with municipal systems that do not have the same cost and profit requirements. See Coalition's Petition for Reconsideration, filed June 21, 1993, at pp. 6 - 10.

^{12/} In the NPRM, the FCC adopted the traditional formulation of cost-of-service standards as the "overarching standard to govern cost-based rates for cable service."

States v. FCC, 707 F.2d 610, 615 (D.C. Cir. 1983), and the FCC's rules incorporate an original cost standard. See Amendment of Part 65 of the Commission's Rules to Prescribe Components of the Rate Base and Net Income of Dominant Carriers, 4 FCC Rcd 1697, 1703 (1989) ("1989 Rate Base Decision"). Recognizing that utility investors are entitled to recoup the full amount of their investment devoted to public service, cf. Democratic Central Committee of D.C. v. Washington Metropolitan Area Transit Commission, 485 F.2d 786, 789-90 (D.C. Cir. 1973), cert denied, 419 U.S. 935 (1974), the FCC has noted that any original cost approach should "permit cable operators to fully recover the costs incurred to construct the plant used and useful in the provision of regulated cable service." NPRM at ¶ 34.

For ratemaking purposes, original cost traditionally has been defined as "the actual money cost of (or the current money value of any consideration other than money exchanges for) property at the time when it was first dedicated to public use, whether by the accounting company or by a predecessor public utility." AT&T Co. v. United States, 299 U.S. 232, 242-43 (1936). Where the cable operator has itself constructed the system, in many cases it should not be difficult for the operator to determine its actual original cost. We recommend that, in these circumstances, the original cost of plant and facilities be included in the rate base. ^{13/}

Under traditional original cost principles, the cost must be depreciated to the present time. See, e.g., AT&T v. United States, 299 U.S. 232, 242-43 (1936); Communications Satellite Corp. v. FCC, 611 F.2d 883, 891 (D.C. Cir. 1977). The

NPRM at ¶ 20, n.20. Each of the components of our proposals is grounded in precedent developed in "traditional" cost-of-service formulations.

^{13/} Where original cost information is not available, we recommend use of reproduction cost, depreciated. See infra pp. 29-32.

Commission has suggested in its NPRM that a uniform, industry-wide depreciation schedule would be appropriate. NPRM at ¶ 26. So long as that schedule is fairly derived, we have no objection. Tony Kern, whose background as a consultant in the cable field spans more than a decade and who has analyzed the cost experiences of more than 6,000 cable systems, proposes that depreciation for cable operators be uniformly restated based on an average 12-year useful life. ^{14/} Mr. Kern's lengthy experience in dealing with the cable industry, as well as his review of massive materials, suggests that under GAAP this period is reasonable for all cable plant. See Kern Declaration at p. 5. Mr. Kern's cost-of-service models contemplate that depreciation be restated to reflect this average useful life on a straight-line basis. We believe that the determination of the original cost of the plant constructed by the existing cable operator, including rebuilds, should be relatively straightforward, and that restating depreciation should not be difficult under Mr. Kern's models.

A more difficult issue arises regarding the inclusion of other costs in the rate base. We remind the FCC that the "law of industry regulation does not prohibit inclusion of noncost elements in the rate base if they are based upon appropriate grounds." Southern Louisiana Area Rate Cases v. FPC, 428 F.2d 407, 426 (5th Cir. 1970), cert denied, 400 U.S. 950 (1970). In this case, where additional moneys must be raised realistically to engage in the cable television business, that investment must also be included in the rate base.

^{14/} We agree with the FCC that depreciation rates for cable operators' tangible plant should be allocated over the "useful" life of the cable plant which, according to Mr. Kern, is on average 12 years. Along the same lines, we think that the FCC should prescribe amortization rates for the intangible portion of the rate base upon the same "useful" life of the cable plant's tangible assets. Mr. Kern notes that this is the typical "investment cycle" for a cable investment.

B. Cable Operators Are Entitled To Include Deferred Start-Up Costs In Their Rate Base.

In its NPRM, the FCC notes that cable operators have made substantial expenditures in early efforts to develop their customer base (including expenditures to create subscriber lists, and obtain franchise and operating rights) "the cost of which will be recovered only as the industry begins to mature." NPRM at ¶ 39, n. 44. In fact, most cable systems incur substantial losses in their early years of operation. The Commission has observed that "large financial losses are common across the industry." NPRM at ¶ 46, n.49. And even such critics of the cable industry as Shooshan & Jackson have noted that the "typical pattern is for a cable system to show accounting losses for six or seven years." Shooshan & Jackson, "Opening the Broadband Gate" (October 1987). Recognizing that write-offs of various early-year costs have resulted in large financial losses, the FCC notes in its NPRM that "[i]t may be reasonable to view such accumulated losses as capital invested with an expectation of recovery over future periods as the industry reaches maturity." NPRM at ¶ 39, n. 44. In fact, the FCC has included a component titled "Deferred System Development Costs" in Part A of Schedule 4 of its proposed Form 326. Whether they are defined as "start-up expenses," "deferred system development costs," or "accumulated losses," we think that cable operators are entitled to recover all such costs and expenses which they reasonably and prudently invested to make their cable systems viable commercial enterprises.

Start-up expenses may be defined as the "excess of expenditures required to build and operate the fixed plant over revenues received from the initially small subscriber base," Stan-Fran Corporation, Docket #AFD-10 and #AFD-2 (Mass. Comm. Antenna Tel. Comm. 1976) at p.5, and courts consistently have recognized that the expense of financing construction and operating a facility during the early unprofitable years of operation to serve customers is itself a

legitimate expense which must ultimately be borne by the ratepayers, Tennessee Gas Pipeline v. FERC, 606 F.2d 1094 (D.C. Cir. 1979), cert. denied, 445 U.S. 920 (1980). In fact, courts and regulatory agencies regularly have permitted public utilities to include deferred start-up costs in their rate base. While some courts have defined start-up costs in terms of "going concern value" (i.e., the difference in value existing between a plant in successful operation and a similar plant assembled but not yet functioning), Wilcox v. Consolidated Gas Co., 212 U.S. 19 (1909), ^{15/} or "deferred operating expenses," ^{16/} all courts consistently have recognized that regulated entities have a right to obtain a return on the cost necessary to make them viable. For example, in McCardle v. Indianapolis Water Co., 272 U.S. 400 (1926), recognizing that "there is an element of value in an assembled and established plant, doing business and earning money, over one that

^{15/} Going concern value includes the investments necessary to organize, establish, construct, and promote the system which are not embraced in the value of the system's actual physical property. See, e.g., Des Moines Gas Co. v. Des Moines, 238 U.S. 153 (1915).

^{16/} An analogous type of cost is "working capital." The FCC traditionally allows carriers to include in their rate base the cash it must keep on hand in order to pay expenses, with the amount of such "cash working capital" calculated by netting revenue "leads", or monies received before bills are due, against revenue "lags", or bills that must be paid before the associated revenues are received. Illinois Bell Tel. Co. v. FCC, 911 F.2d 776, 783-84 (D.C. Cir. 1990), appeal after remand, 988 F.2d 1254 (D.C. Cir. 1993). While not referring to such amounts as "start-up costs," the FCC consistently has recognized that regulated entities must be compensated during the lag between the time when cable operators incur expenses and recover these expenses. "The FCC's rationale for including cash items in working capital is that they require the carrier to expend money before receiving the related revenue, that is tantamount to making an investment in the rate base upon which the carrier is entitled to earn a return." Illinois Bell, 911 F.2d at 784. Similar to a working capital allowance, cable operators must be able to recover the funds they need to expend to pay operating expenses prior to the time a sufficient revenue stream becomes available. Because most cable operators charge in advance for services, Mr. Kern has not included any amount specifically to represent working capital in the rate base.

is not thus advanced," the Supreme Court held that a regulated water company was entitled to include in its ratebase not only the monies it expended in developing its water system, but also an amount attributed to the value of the operational water system "in excess of the value of the pipe, buildings, ground and machinery." Id. at 413-14. The Supreme Court held that it was appropriate for the water company to obtain such a return on the "going concern" value of its water system because it made up "an element of value that is actual and not speculative . . . [and which] would be considered by a buyer or seller of the property." Id. at 414. In a case involving cable television, Teleprompter Cable Communications Corp. v. Board of Public Utility Commissioners, 154 N.J. Super 1, 380 A.2d 1140, 1144-45 (1977), the court held that the "going concern" value of a cable television distribution company is a property right and that a cable television distributor was entitled to include it in its rate base.

It is well-recognized that when a utility introduces new services into an area it must recover its start-up costs in its rate base in order to adequately compensate its investors and attract the capital necessary to continue service. See, e.g., St. Lawrence Gas Co. v. Public Service Commission, 42 N.Y.2d 461, 368 N.E. 2d 1234, 1236 (N.Y. 1977). Moreover, if a utility cannot attract customers by charging initial rates high enough to recover its start-up costs, it is just and reasonable for the utility to charge future customers the unrecovered portion of the start-up costs because these customers benefit from the service which would not have become available absent the initial investment. Id. In another case involving the cable industry, Stan-Fran Corporation, Docket #AFD-10 and #AFD-2 (Mass. Comm. Antenna Tel. Comm. 1976) at p.5, the Massachusetts Cable Commission permitted a cable company to include its initial unrecovered operating expenses in its rate base on the grounds "they represent funds prudently invested in the

construction and maintenance of the system at the time when the bulk of expenditures had to be made." ^{17/}

The FCC also has recognized this need to include deferred start-up expenses in the rate bases of regulated companies. For example, in the Comsat case, the FCC explicitly permitted the carrier to include in its rate base "deferred start-up costs." Communications Satellite Corp., 56 F.C.C.2d 1101, 1138-39, 1184 (1975), remanded on other grounds, Communications Satellite Corp. v. FCC, 611 F.2d 883 (D.C. Cir. 1977). The FCC recognized that, while an entity's start-up costs and operating expenses may be so great that it could not charge its initial customers a rate sufficient to recover such costs and expenses, it is entitled to recover those costs and expenses and may charge some of these start-up costs to later customers. See, e.g., Comsat, 611 F.2d 883, 895-96.

While a utility generally may not set rates to recoup past losses that have been incurred under regulated rates, Nader v. FCC, 520 F.2d 182, (D.C. Cir. 1975); Illinois Bell Tel. Co. v. Alphin, 95 Ill. App. 3d 115, 419 N.E.2d 1188, (1981), aff'd., 93 Ill.2d 241, 443 N.E.2d 580 (1982), a utility is entitled to recover the investment it has made in developing, planning, constructing, and initially operating its plant until revenues are sufficient to cover all of its expenses. Where a utility which is already subject to regulation is unable to achieve a prescribed rate of return, the loss falls on the utility's investors as a risk of the enterprise. Of course, that utility had an opportunity to contest that rate when it was set on the ground that it would not give the utility an "opportunity" to recover its costs and a

^{17/} Cable operators' early-year operating losses represent the cost of building up a sufficient subscribership to begin to achieve necessary economies in system operation. In essence, these losses are the cost of developing the system's subscriber lists. See NPRM at ¶ 34 and ¶ 39, n.44. Because the investment necessary to cover these early losses -- and thereby develop the subscribers lists -- must be raised, the investment should be included in the rate base.

fair return. In these situations, the reason for the loss must, therefore, be attributed to the utility's bad management. Conversely, a cable television operation has a predictable period of operating losses before profitability that must be funded with investor dollars. To place these losses in the rate base is not to require future ratepayers to retroactively compensate for some deficiency in the way the cable system is operated. It is to cover the inevitable early expenses that permit the later subscribers to receive service at all. To the extent cable operators have not recovered fully their early operating expenses, they must be permitted to include such unrecovered expenses in their rate base. 18/

C. Operators Are Entitled To Budgeted Capital Expenditures To Be Made Within Twelve Months.

In its NPRM, the FCC notes that "in the near future, cable operators may experience significant competition in delivery of video programming to consumers" and that any cost-of-service standards "should not thwart operators' ability to respond to competitive forces by means of facility and service improvements." NPRM at ¶ 9. The FCC tentatively concludes that to permit (and encourage) capital improvements "cost-based rates should be designed to assure that cable operators may fully respond to incentives to provide a modern communications infrastructure and to respond to competitive forces." NPRM at ¶ 9. In order to respond in a marketplace where technology changes on a daily basis,

18/ We recognize that cable operators are not entitled to receive a double recovery, and if the cable operators' revenues have offset some of its expenses, they may not be included in the rate base. See, e.g., McCardle v. Indianapolis Water Co., 272 U.S. 400 (1926)(costs that have already been expensed may not be recovered as part of going concern value); see also Houston v. Southwestern Telephone Co., 259 U.S. 318 (1922))(whether going concern value should be considered and allowed at all in determining the base for ratemaking, and if allowed what the amount of it should be, depends upon the financial history of the company).

cable operators typically must plan upgrades in their system a year in advance so that they will have the requisite lead time to install the new equipment and/or make the necessary improvements in their facilities to service their subscribers. Recognizing that lead time often is necessary to order, install, and implement technical upgrades and improvements in facilities, the FCC has stated that telecommunications entities must be able to include in their rate base the construction costs that are anticipated within the next twelve months. See Communications Satellite Corp. v. FCC, 611 F.2d. 883 (D.C. Cir. 1977). If cable operators do not have access to the funds to make investments for technical improvements within the next year, they cannot be expected to provide a modern communications infrastructure and remain competitive. Accordingly, the FCC must allow cable operators to include in their rate base all budgeted capital expenditures to be made within the following twelve months.

D. Operators Are Entitled To Recover In Their Rate Base
Interest Paid To Borrow Funds During Construction
And Early Years Of Operation.

As noted above, any person who contemplates constructing a cable television system necessarily must obtain the financing to cover the costs of constructing the system plus the cumulative difference between the system's revenues and operating expenses (plus interest), until revenues equal or exceed these expenses on an annual basis. The funds that cable operators expend to finance construction and the early operation of the system constitute an investment that is "used and useful" for the provision of cable service and cable operators must be permitted to include these funds in their rate base.

The FCC refers to the funds necessary to fund construction as "Allowance for Funds Used During Construction" or "AFUDC" and has permitted these funds to be added to the rate base by compounding the prime rate. See, e.g.,

1989 Rate Base Decision 4 FCC Rcd at 1703; Illinois Bell Telephone Co. v. FCC., 911 F.2d 776, 782 (D.C. Cir. 1990), appeal after remand, 988 F.2d 1254 (D.C. Cir. 1993). "The theory behind compensating for interest during construction is that the cost of an addition to the existing plant structure includes payments not only for physical materials but for finance charges of borrowed money as well."

Communications Satellite Corp. v. FCC, 611 F.2d at 895. To the extent cable operators have not recovered fully funds they paid to borrow capital to cover the costs of construction, as well as operating losses in the start-up phase, they should be permitted to include such unrecovered funds in their rate base. We note that allowing interest on construction costs and deferred start-up costs during the period before the system reaches profitability is not only fair, it is conservative. We have not proposed to include any foregone profits for this period, see NPRM ¶ 39, n.44, and have instead included the lower compounded interest expense. See 1989 Rate Base Decision, 4 FCC Rcd at 1701.

E. Depreciation Should Be Included And Deferred.

In its NPRM, the FCC recognizes that cable operators must be permitted to recover depreciation. NPRM at ¶ 25. In fact, the FCC has stated elsewhere that "depreciable assets are included in the rate base and earn a return until the costs are recovered through depreciation." 1989 Rate Base Decision, 4 FCC Rcd at 1703. Furthermore, the FCC has recognized the need to fully recover depreciable assets by deferring depreciation expenses for regulated utilities until long-term construction projects are placed in service. The result of this deferral is to permit depreciation to be recovered completely from ratepayers when they begin to utilize the newly constructed plant. We urge the FCC to treat depreciation as an expense that must be recovered.

Because depreciation is a "non-cash" expense, however, we suggest that cable operators should not recover depreciation until after they have recovered all cash expenses (i.e., start-up expenses and interest expenses). This approach is consistent with the FCC's explicit recognition that "depreciable assets are included in the rate base and earn a return until the costs are recovered through depreciation." 1989 Rate Base Decision, 4 FCC Rcd at 1700 (emphasis added); see also Illinois Bell Telephone Co. v. FCC, 911 F.2d at 983. In its 1991 Rate Base Decision, the FCC apparently agreed that depreciation must be deferred until it can be recovered. Amendment of Part 65 of the Commission's Rules to Prescribe Components of the Rate Base and Net Income of Dominant Carriers, 7 FCC Rcd 296 (1991) (the "1991 Rate Base Decision"). 19/

Until revenues are sufficient to cover depreciation as well as cash expenses, depreciation is not actually recovered. Accordingly, any unrecovered depreciation expenses should also be deferred and retained in cable operators' rate bases until they can be recovered by revenues. By retaining unrecovered depreciation in the rate base, the FCC would, in essence, be treating the assets as undepreciated until revenues are sufficient to begin to recover depreciation. This treatment is entirely consistent with the need to allow the actual recovery of all depreciation.

19/ We are not suggesting that any return on the depreciable plant be compounded into the rate base and, therefore, there should not be any question of a double recovery as to the depreciable plant.